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ACCOUNTING FOR LEASES

Report of the UNCTAD secretariat

SUMMARY

In recent years, the frequency with which entities use leasing as a method of acquiring capital assets or encouraging sales thereof has increased dramatically. Lease financing has advantages and disadvantages compared to either an outright cash purchase or obtaining financing from a third party. Generally, the majority of countries have either adopted International Accounting Standards (IASs) (IAS 17 - Accounting for Leases) or have accounting practices which generally conform with IAS 17. IAS 17 prescribes relatively straightforward requirements, which have been interpreted and applied consistently in many countries, usually without the need for extensive, subjective judgements. Areas of controversy include the validity of the distinction between an operating lease and a financing lease, how to differentiate between operating and finance leases, sale-leaseback arrangements, and more complex lease financial transactions.

* E/C.10/AC.3/1994/1.

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INTRODUCTION

1. This report was prepared in order to provide the Intergovernmental Working Group of Exports on International Standards of Accounting and Reporting with a review of the issues and practices in accounting for lease transactions (see E/C.10/AC.3/1989/7).

2. The accounting treatment for leases is relatively straightforward, with most of the requirements clearly stated within relevant international and some national accounting standards. Uniform practices have been adopted in many counties which are easily interpreted, resulting in transparency between financial statements dealing with this particular aspect of accounting. There is either a requirement for leases to be capitalized, and the procedures used are relatively harmonious, or more legal and taxation orientated accounting principles are adopted with the lease instalments being treated in the same manner as rental payments are expensed.

3. This report is a description of the issues involved and a discussion of the accounting treatment of lease transactions in the context of the objectives and concepts underlying financial statements. It also outlines some current national practices on a comparative basis, noting the relevant international standards.

4. Lease accounting records a transaction in which the owner of property (the lessor) grants another party (the lessee) the right to control and enjoy the benefits of ownership of the property, the consideration being periodic rental payments. A lease agreement specifies the terms and conditions of the arrangement.

5. Australia, Botswana, Canada, France, Israel, Kenya, Malaysia, Mexico, Pakistan, the United Kingdom of Great Britain and Northern Ireland and the United States of America are among the countries that have either directly adopted international standards or have accounting standards and practices in conformity with IAS 17. Notable exceptions to this practice are found in Austria, Brazil, Colombia, Finland, Germany, India, Italy, Japan and Switzerland. The United States has the most extensive and thorough national guidelines specifying how the more unusual and complex lease transactions should be treated. For instance, the treatment of sale-leaseback transactions, leases involving real estate, changes in lease provisions or terms and leveraged leases all must be accounted for in accordance with specific provisions of United States accounting standards. The practices prescribed in IAS 17 are closely aligned with those prevailing in the United States, although they are not as comprehensive. However, procedures have been developed in the United States over many years and reflect complex financial transactions in a highly developed capital market structure.

6. Section I below presents a summary of findings, section II describes the accounting treatment of leases and discusses problems encountered, and section III presents conclusions and recommendations.

I. SUMMARY OF FINDINGS

A. Significance of accounting for leases

7. Throughout the 1980s, the extent and number of lease transactions grew exponentially as companies financed a greater proportion of their fixed assets through leasing agreements. The following table indicates the increasing reliance upon leasing as a means of financing the purchase (and promoting the sale) of assets.

Year	ECU billions	Increase or decrease over previous year (percentage)
1982	15.8	-
1983	19.6	+24.1
1984	21.5	+ 9.7
1985	29.1	+35.4
1986	36.1	+24.1
1987	51.7	+43.2
1988	69.5	+34.4
1989	82.1	+18.1
1990	95.2	+16.0
1991	94.5	- 0.7
1992	89.0	- 5.8

Source: Leaseurope, European Federation of Equipment Leasing Associations, "Annual Report 1992".

8. There are a number of economic advantages to leasing assets as opposed to purchasing them outright, which include the following:

(a) The lessee can acquire modern equipment without ownership risk and subsequently update such items with newer equipment either during or at the conclusion of the contract;

(b) A lessee can obtain equipment without a deposit or by making a relatively small up-front payment, thereby facilitating a smooth cash flow;

(c) If the lease is not capitalized, the debt will not appear on the balance sheet (known as "off balance sheet financing"), thereby effectively presenting a lower debt-to-equity ratio and a higher working capital ratio;

(d) A lessor may be able to boost sales by offering lease/purchase options;

(e) The lessor may retain ownership of the asset at the conclusion of the contract and thereby take advantage of its residual value for future leasing arrangements or for subsequent sale;

(f) Both the lessor and lessee can structure the lease agreement provisions in order to obtain the best possible taxation benefits;

(g) If a lessee does not have an adequate equity capitalization or working capital for the purchase of certain assets (from either its own cash flows or to satisfy commercial bank lenders), a financing company may be willing to provide the working capital for the acquisition.

9. Accounting standards are written to ensure conformity and transparency in the treatment of transactions and events which have a material impact on financial statements. As the above table indicates, the extent of leasing as a means of financing acquisitions of capital equipment is substantial, which means that it is imperative to consider the implications for financial reporting. Further, as there are many advantages of using lease financing for asset acquisitions, its usage has become widespread.

B. Accounting for leases: objectives and concepts

10. It is widely agreed that the objective of financial statements is to provide useful information to an extensive variety of users for decision-making purposes and to maintain the stewardship of management for resources entrusted to them. The information should be relevant, reliable, comparable and understandable.

11. The purpose of the balance sheet is to provide a description of the financial resources available to the company for the generation of income, how those resources were obtained, and an indication of the financial strength of a company in a manner that should help users judge the ability of the company to meet its obligations. The profit and loss statement should present some measure of the effectiveness and extent to which those resources were utilized and an indication of the assets employed and facilities depleted.

12. A key concept governing the recognition of assets requires not only the expectation of future economic benefits but also the measurement of the assets with sufficient reliability and regard to the need to exercise prudence in judging the uncertainty of future outcomes (see E/C.10/AC.3/1990/9). Traditionally, it has always been required that the balance sheet should only report assets for which legal title is held.

13. The most significant factor determining the various accounting treatments of leases is the recognition of the ownership of assets. The point of contention is whether to include assets in a balance sheet notwithstanding that legal title to those assets is vested in another party. The form of the arrangement is the crucial perspective. The lease contract is often construed to transfer ownership effectively in terms of the benefits and privileges. Essentially, the substance of the transaction must be considered. The major point of contention between national standard setters in deciding to capitalize leases is whether metaphorically to acknowledge control over an asset despite the lack of legal title. The terms of the lease agreement are paramount in determining the intention of the parties involved.

14. Historically, leases have been treated as simple rental agreements. In some countries there have been incidents of perceived weaknesses in financial statements in situations where significant non-cancellable lease obligations were alluded to only very fleetingly in notes to the financial statements. However, some leases are essentially the same in nature as debt-funded purchases. Capitalization of leases seeks to correct this deficiency. To produce fair and true financial statements, the accounting profession in many countries has adopted the economic and financial substance of lease arrangements rather than their legal form.

C. Accounting guidelines for the treatment of leases

15. When leases are accounted for using guidelines which are in conformity with IAS 17, there are chiefly two types or classifications, namely, financing leases and operating leases. A financing lease has terms which are aimed to ensure to the lessor the full recovery or almost all of the purchase price of the asset in addition to financing and other costs. Essentially all the risks and benefits of ownership are transferred from the lessor to the lessee, without the actual legal transfer of title. All other leases are considered to be operating leases. Under an operating lease, the benefits and costs of ownership remain with the lessor, the lessee simply paying a given sum for the privilege of using the asset during the lease period. Upon expiration of the lease term, possession of the asset reverts to the owner/lessor. The lessor is usually responsible for the repairs and maintenance of the item throughout the contractual period.

16. However, when a particular country's accounting standards do not require leases to be capitalized, lease payments are simply treated as expenses in the accounts of the lessee and as income for the lessor, and lease assets and liabilities are usually not disclosed. In some countries, enterprises may explain in the notes to their financial statements the extent and impact of their lease transactions.

17. In either situation, it is recommended that sufficient disclosure concerning the accounting policy adopted will allow users of the statements to make their own analysis to assess the impact of alternative accounting methods for leasing transactions. This disclosure approach would be consistent with evidence from research on capital markets which suggests that investors can make adjustments for accounting differences, provided that sufficient information is

disclosed (see E/C.10/AC.3/1990/9). More significantly, users are as concerned with full and complete disclosure as they are with the actual content of the statements. The principle of transparency is vital to enable users to interpret financial statements when there is more than one acceptable accounting treatment or some degree of flexibility allowed, because with sufficient background information, potential confusion or misunderstanding can be minimized.

18. The "matching principle" that accountants strive to enforce is tested considerably by leases and can result in discrepancies in accounting periods where it is likely that the lease cost will differ from the cash flow amount. Lease transactions should be considered within two conceptual frameworks: one is the financing aspect of the arrangement, which comprises of the financing charge and related liability; the other is the asset and the amortization expense, which should be in accordance with the depreciation policy of other non-monetary assets.

II. ACCOUNTING TREATMENT OF LEASES

Recognition and measurement of leases

19. As mentioned above, there are two significantly differing approaches to accounting for leases; that is, to capitalize transactions or not. The IASC's international accounting standards specify that financing leases should be capitalized. The extent to which various countries comply with this standard, and whether there are national requirements, is shown in the table below.

20. Of the 59 countries surveyed, only 18 utilize procedures that do not generally conform with IAS 17. Nearly 70 per cent of the countries have national requirements that conform, at least in all material aspects, with IAS 17 or they have adopted IAS 17. Moreover, approximately 25 per cent of the countries surveyed have national practices which have adopted IAS 17 or used the international standard as the basis for the national requirement.

Table. Comparative national conformity to IAS 17

Country or territory	IAS adopted as a national requirement	IAS used as the basis for a national requirement	National requirement developed separately and conforms in all material respects with IAS	No national requirements but national practice generally conforms with IAS	National requirement developed separately but does not conform with IAS	No national requirements and national practice does not generally conform with IAS
Australia			X			
Austria					X	
Bahamas	X					
Barbados	X					
Belgium			X			
Botswana	X					
Brazil						X
Bulgaria			X			
Canada			X			
Colombia					X	
Cyprus	X					
Czech Republic						X
Denmark						X
Egypt				X		
Fiji			X			
Finland					X	
France			X			
Germany					X	
Ghana						X
Greece						X
Hong Kong			X			
Hungary					X	
Iceland			X			
India					X	
Israel				X		

Country or territory	IAS adopted as a national requirement	IAS used as the basis for a national requirement	National requirement developed separately and conforms in all material respects with IAS	No national requirements but national practice generally conforms with IAS	National requirement developed separately but does not conform with IAS	No national requirements and national practice does not generally conform with IAS
Italy						X
Jamaica						X
Japan						X
ordan	X					
Kenya			X			
Korea, Republic of					X	
Malawi	X					
Malaysia	X					
Malta						X
Mauritius		X				
Mexico			X			
Netherlands			X			
New Zealand			X			
Nigeria			X			
Norway		X				
Pakistan	X					
Philippines				X		
Poland						X
Portugal			X			
Saudi Arabia				X		
Singapore		X				
South Africa		X				
Sri Lanka		X				
Swaziland	X					
Sweden					X	
Switzerland				X		

Country or territory	IAS adopted as a national requirement	IAS used as the basis for a national requirement	National requirement developed separately and conforms in all material respects with IAS	No national requirements but national practice generally conforms with IAS	National requirement developed separately but does not conform with IAS	No national requirements and national practice does not generally conform with IAS
Taiwan, Province of China			X			
Thailand			X			
Trinidad and Tobago				X		
United Arab Emirates				X		
United Kingdom			X			
United States			X			
Uruguay				X		
Zimbabwe	X					
TOTALS	10	5	18	8	8	10

Source: International Accounting Standards Committee "Survey of the use and application of International Accounting Standards 1993" (Draft release).

Capitalization of financing leases

21. A lease under which the risks and benefits of ownership related to the leased property are essentially transferred from the lessor to the lessee is classified as a financing lease. Tests have been adopted to identify the notion of "transfer of risks and benefits", and it is considered to have occurred if each of the following criteria are present:

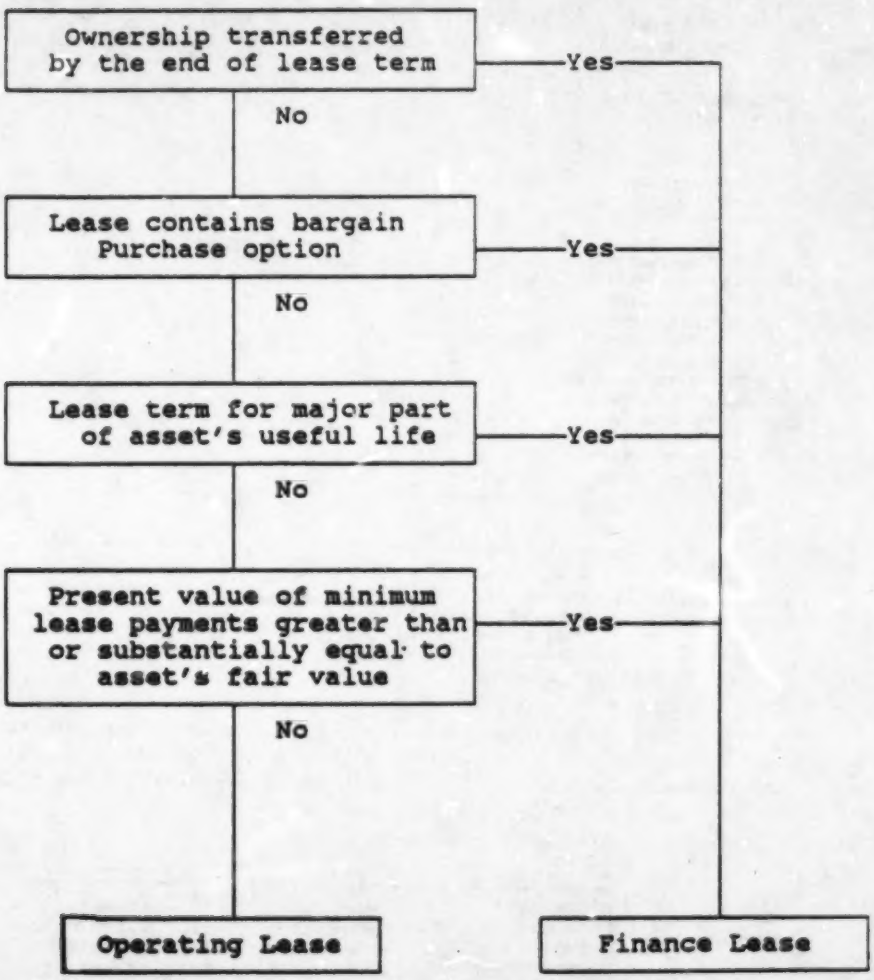
(a) There is a bargain purchase option for the lessee at the conclusion of the lease period if there is a purchase option at all;

(b) The lease term comprises a significant portion of the asset's useful, productive life (for example, 75 per cent);

(c) The present value of the aggregate minimum lease instalments payments is greater than or equal to substantially all of the fair value of the asset (usually the test requires that the ratio is at least 90 per cent).

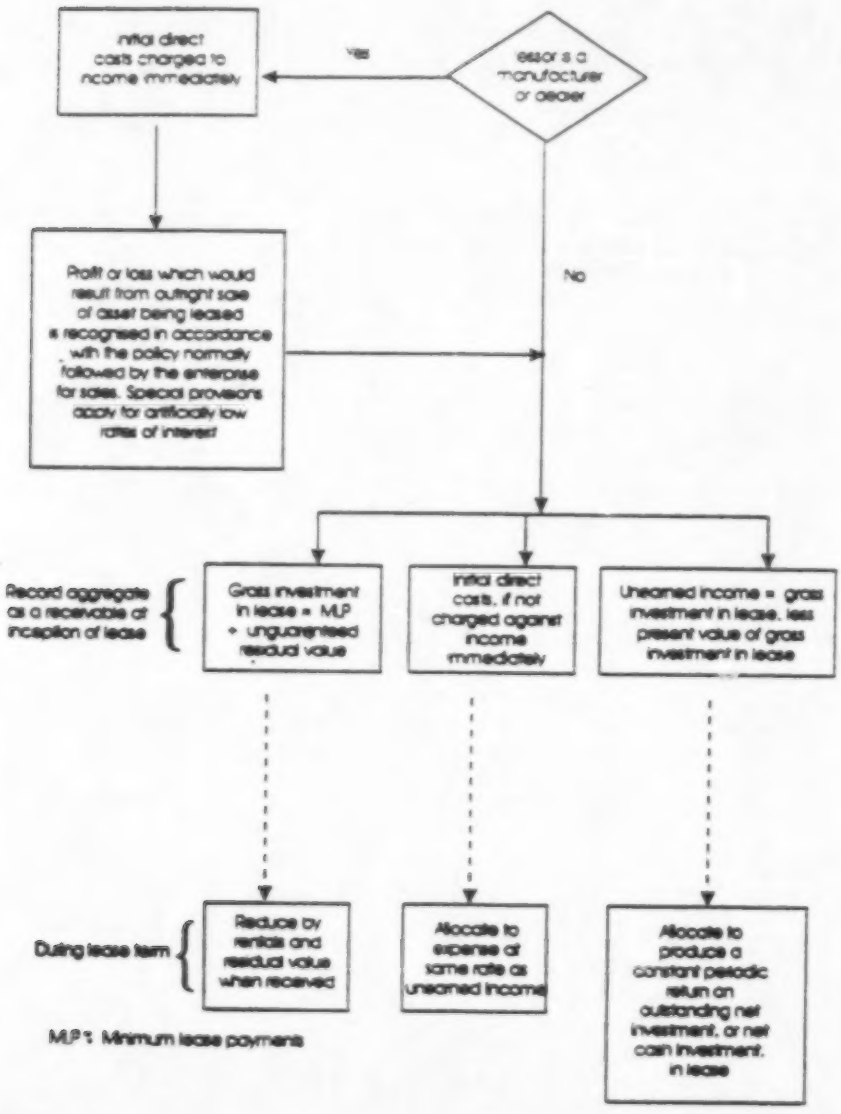
Flow Chart I

The distinction between an operating lease and a finance lease



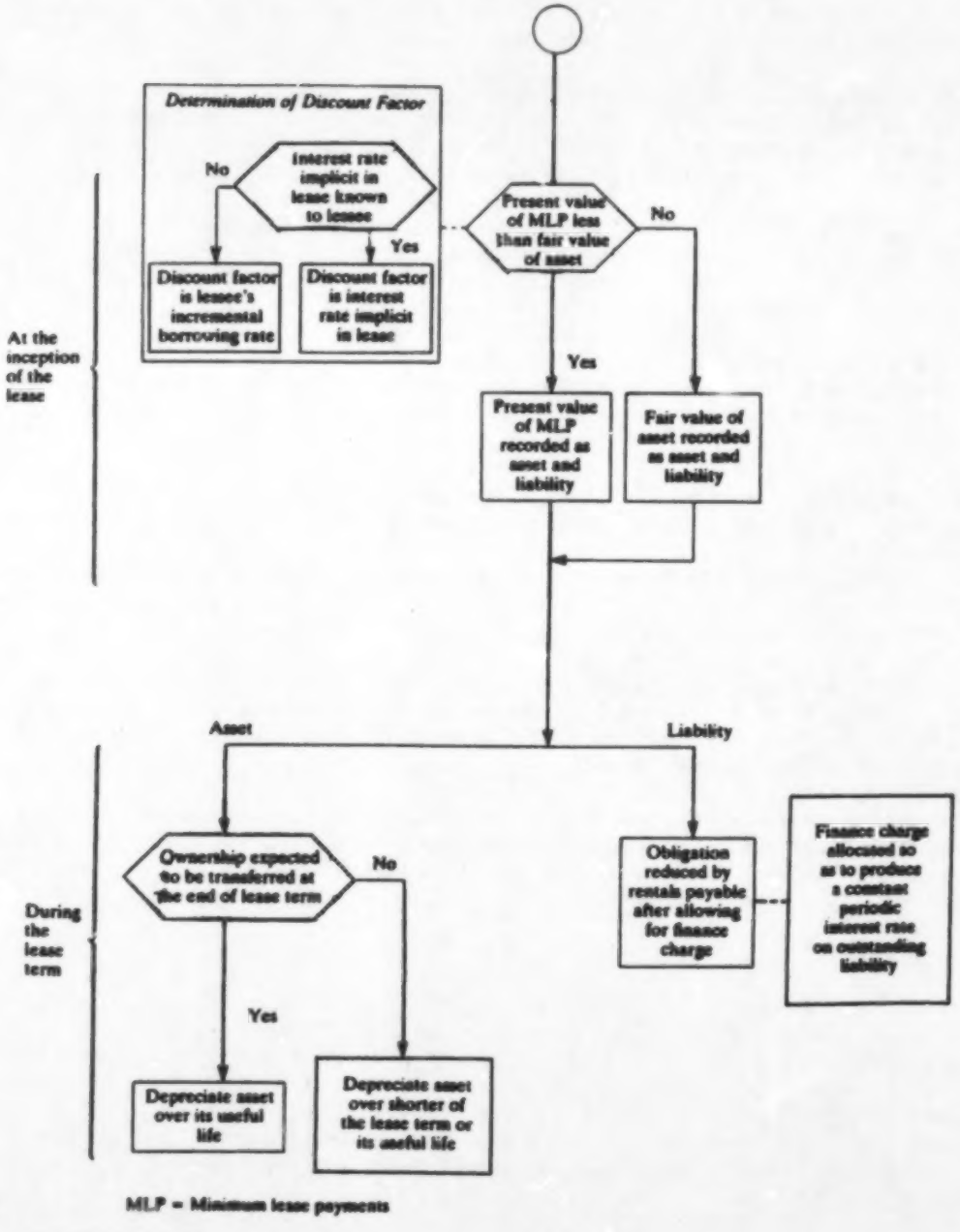
Flow Chart II

Accounting for a finance lease by a lessor


Initial direct costs charged to income immediately
Yes
Lessor is a manufacturer or dealer
Profit or loss which would result from outright sale of asset being leased is recognised in accordance with the policy normally followed by the enterprise for sales. Special provisions apply for artifically low rates of interest
No
Record aggregate as a receivable at inception of lease
Gross investment in lease = MLP + unguaranteed residual value
Initial direct costs, if not charged against income immediately
Unearned income = gross investment in lease, less present value of gross investment in lease
During lease term
Reduce by rentals and residual value when received
Allocate to expense at same rate as unearned income
Allocate to produce a constant periodic return on outstanding net investment, or net cash investment, in lease
MLP: Minimum lease payments

Flow Chart III

Accounting for a finance lease by a lessee


At the inception of the lease
Determination of Discount Factor
No
Interest rate implicit in lease known to lessee
Yes
Discount factor is lessee's incremental borrowing rate
Discount factor is interest rate implicit in lease
Present value of MLP less than fair value of asset
No
Yes
Present value of MLP recorded as asset and liability
Fair value of asset recorded as asset and liability
During the lease term
Asset
Liability
Ownership expected to be transferred at the end of lease term
No
Yes
Depreciate asset over its useful life
Depreciate asset over shorter of the lease term or its useful life
Obligation reduced by rentals payable after allowing for finance charge
Finance charge allocated so as to produce a constant periodic interest rate on outstanding liability
MLP = Minimum lease payments

Source: International Accounting Standards Committee, "International Accounting Standards 1993", pp. 220-222.

22. Once the decision has been made to capitalize a lease the following steps are usually taken:

(a) The leased asset and corresponding liability are recorded as an amount equal to either the fair value of the asset or the present value of the minimum lease payments, whichever is the smaller;

(b) The asset is amortized in accordance with the normal deprecation policies adopted by the enterprise, or is amortized over its estimated useful life if there is a bargain purchase option or if a transfer of ownership has occurred; otherwise, amortization is over the duration of the lease term;

(c) Each lease instalment is allocated between a reduction of the lease liability and the interest expense or finance charge, thereby reducing the associated liability. The interest rate used is usually the rate implicit within the lease agreement.

23. The related disclosures also vary from country to country, although the underlying basis is relatively similar throughout countries where leases are mandatorily capitalized. Generally, the following disclosure requirements are adopted:

(a) Asset values show the initial amount capitalized with accumulated amortization showing as a deduction, analysed by major categories of assets;

(b) The liabilities pertaining to the leases are usually allocated between current and non-current portions; sometimes the liabilities are reconciled to the outstanding lease commitments and uncharged future finance expenses;

(c) Outstanding lease payments are usually classified by the accounting periods in which they fall due; for instance, less than one year after the balance date, between one and two years, two to five years, and beyond five years from the balance sheet date;

(d) Other details which are sometimes disclosed include a general description of leasing arrangements where a lease is capitalized but the lessee is not the legal owner, and any significant restrictions placed upon the lessee as a result of the lease agreement.

Leveraged leases

24. A leveraged lease is accounted for by the lessee in the same fashion as a non-leveraged lease. However, this type of lease has significant ramifications to the lessor. Under this arrangement, the lessor borrows all or part of the asset cost from a third party (a creditor) and acts as an intermediary between the lessee and the creditor by way of the lease contract. Thus, leveraged leases are only considered to be different from non-leveraged leases from the viewpoint of the lessor. A leveraged lease possesses each of the following attributes:

(a) More than two parties are contracted, the lessee, the lessor and one or more long-term creditor(s);

(b) The financing facilities provided by a creditor are usually significant and are usually non-recourse to the lessor;

(c) The lessor's net investment generally rises during the later stages of the lease term;

(d) Any investment tax credits are usually retained by the lessor and are accounted for as one of the financial and cash flow components of the lease.

25. Lessors account for investments in leveraged leases net of recourse debt. Income is recognized when the investment, net of deferred taxes, is positive.

26. The purpose of leveraged lease arrangements is to allow lessors to obtain additional financing for their operating activities.

Sale-leaseback arrangements

27. The main issue in sale-leaseback transactions is the treatment of the profit (or loss) on such transactions. Generally, the profit or loss is amortized over the period of the lease or the life of the asset, whichever is the shorter. Through these arrangements, unrealized appreciation in the values of assets effectively can be converted into realized gains flowing through the profit and loss. The inconsistency arises due to the treatment of the depreciation of the asset over its estimated useful life, which is often longer than the life of its lease agreement. Hence there could be mismatching of the realization of the gain and the recording of the depreciation expense.

Transactions that involve land and buildings

28. Some countries, in particular the United States, have developed extensive standards dealing with the issue of leases and real estate. The Australian standard also requires such leases to be capitalized if the appropriate criteria are met. If the fair value of the land at the commencement of the lease is less than 25 per cent of the fair value of the property, the leased property is considered as a single unit for classification purposes. The useful life of the building is deemed to be that of the property. However, if the land component is greater than 25 per cent of the total value, then the land and buildings are considered separate for classification purposes. However, the Canadian standard states that if the fair value of the land is significant (the Australian 25 per cent "rule of thumb" is not used), as a proportion of the overall value of the property, the land and buildings would be separately disclosed. It would be the usual practice to amortize the building in line with the depreciation policies adopted by the company, and the land value would normally not be amortized.

Leases that involve real estate in a sale-leaseback

29. Parties to these agreements wish to seek the best possible taxation, cash flow, accounting and reporting outcomes. The United States has developed extensive guidelines to handle these transactions, which have grown very complex in some cases. Reporting rules have been formulated for real estate with

commercial office buildings, manufacturing facilities and processing facilities such as pipelines and refineries.

30. The United States guidelines for sale of real estate with subsequent leaseback require a determination of the gain that would have been reported had the transaction not involved a simultaneous leaseback. This gain is then treated under the guidelines of leases, that is, to be deferred and amortized. However, a gain would be reported as income to the extent that the proceeds of the sale exceed either (a) the discounted value of the minimum lease payments when the transaction does not meet the requirements to capitalize the lease, or (b) the recorded amount of the leased asset when the lease does meet the requirements to capitalize. 1/

Leases which involve only part of a building

31. When the leased property involves only part of a larger building, for example an airport, a bus terminal or a port facility, its fair value may not be easily or objectively determinable. Furthermore, special provisions may also exist in the lease agreements for these particular types of property and the economic life of such facilities for purposes of classification of the lease is essentially indeterminate. As the lessor (usually a governmental body) is not likely to transfer ownership, the most appropriate treatment is that of an operating lease.

Sales-type leases

32. The United States Financial Accounting Standard Board's (FASB) Statement of Financial Accounting Standards (SFAS 13) specifies the treatment of sales-type lease transactions. The treatment suggests that the lessor must take into account the residual value of the asset involved. The unguaranteed residual value and the minimum lease payments to be received represent the lessor's gross investment in the lease. The difference between the gross investment and the sum of the net present value of the two components of which it comprises represents unearned income, which is amortized over the lease period. The present value of the minimum lease payments computed at the interest rate implicit in the lease is considered to be the sales price. The cost of sales is the historical cost, plus any initial direct cost, less the present value of the unguaranteed residual value accruing to the lessor, also calculated using the same implicit interest rate.

Leases of forests or fishing rights

33. The cost of income-producing land such as forests and fishing rights is amortized on a units-of-production method over the expected units to be removed from the forest or fishing area. Costs of re-forestation and for the replenishment of fish may be charged as current operating expenses or to the accumulated amortization of the leasehold interest. In any event, the forest or fishing right costs must usually be amortized to accounting periods at no less than a straight-line method amount, since the rights expire at a fixed time (the expiration date or when the renewal option is exercised). Such transactions are usually treated as operating leases.

Leases for mineral and timber resources

34. Reclamation costs should be accrued and expended on a units-of-production basis, in line with usual accounting standards.

Treatment and definition of operating leases

35. Traditionally, the definition of operating leases refers to those leases which are not considered to be financing leases. The accounting method used for an operating lease is significantly simpler than for financing leases. Usually, the expense is recognized on a straight-line basis, regardless of the payment schedule. However, in some countries the expense may be recognized on some other systematic or rational basis that is more representative of the pattern in which the user derives benefit, such as on a units-of-production basis. As ownership effectively and legally remains with the lessor, the lessee does not record a lease asset, nor is any liability for an asset purchase recorded. However, the notes to the financial statements would normally show the outstanding lease commitments for non-cancellable leases in total and further details for the amounts payable within one year after the balance sheet date, two to five years thereafter, and greater than five years.

Non-capitalization of leases

36. In countries where leases are categorized as either financing leases or operating leases, the question is raised as to whether or not this distinction is really valid, and whether accounting should try to present the substance of the transaction instead of just its form. It is often argued that if title has not passed hands legally, then recognition of an asset is misleading. Nevertheless, a resource is being used in order to generate income, and it could also be misleading to ignore this factor; and there exists the ongoing financial commitment that must be serviced from the income generated by the asset. Usually lease contracts which have been classified as financing leases do not actually involve the transfer of legal title at the inception of the contract but the lessee has the option to purchase the asset at the end of period of time. Nevertheless, accounting requirements specify that the item should be capitalized.

37. More attention and weight should be paid to the substance of the transaction rather than its form. An important question is the difference between a financing lease and an operating lease and whether differing accounting treatments are justifiable. This distinction centres on the notion of "transfer of ownership", but ignores the financial responsibility and consequences of the two types of leases which have virtually the same financial impact. Furthermore, the guidelines are often interpreted in a very literal manner, which defeats their purpose. The guidelines are intended to be a basis for differentiation, not to over-rule the substance of the transaction.

38. All leases convey to the lessee the right to enjoy the benefits of leased property for an obligation to transfer economic compensation to the lessor. The tests developed have simply become a challenge for some calculating accountants and legal and financial advisors to circumvent the guidelines. Consequently, the non-recognition of in-substance financing leases reduces the perceived

leverage of entities and may increase the availability of other financing to them, and/or lower costs. Also when Governments do not recognize lease liabilities which are in-substance financing leases, they are able to obtain access to funds that are not subject to asset-purchase borrowing limits specified by parliamentary or budgetary constraints. Furthermore, the availability of operating leases remains unhindered. 2/

39. An operating lease is a considerably different type of transaction from a rental, which is usually for a short period of time, often as little as one day up to approximately a year. Personal property operating leases may span a period of 5 to 10 years, and real estate leases much longer, and if non-cancellable, can place a significant financial burden upon an enterprise's cash flow over a period of time and represent a significant resource expended in generating profits.

40. It would be misleading to portray an asset at an enterprise's disposal as a freehold if it was actually an operating lease without the intention of the lessor and lessee for title to ever change hands. However, if the item is adequately noted as being under-lease but not owned, with appropriate notes to the accounts regarding the accounting policies adopted, the distortion due to off balance sheet financing could be overcome, and any confusion as to ownership and resources utilized and controlled would also be mitigated.

Anomalies in lease accounting

41. Certain aspects of the guidelines which govern the accounting treatment for leases are open to interpretation and manipulation. Generally, there is an overwhelming reluctance to capitalize leases, and lease contracts can be structured in such a way as to avoid this requirement, particularly by using a strict, literal interpretation of the accounting standards and by following the actual form of the transaction. It can be argued that true and full disclosure of all lease commitments would circumvent this problem. However, the complexity of lease transactions and the significant impact they can have on the balance sheet makes a simple adjustment difficult and probably inaccurate. Greater disclosure cannot adequately substitute for capitalization, given the reliance and utilization of balance sheets by decision-makers.

The 90 per cent of net present value test

42. One of the criteria frequently used to refer to the transfer of risks and benefits of ownership in a lease contract is the test referred to as "substantially all". It is a vital key to defining the type of lease contract. The test most often formulated is: if the present value of the minimum lease payments if 90 per cent or more of the fair value of the leased asset, then the lease is a financing lease. However, in practice this guideline is often interpreted quite literally, with leases being written whereby this percentage is marginally less than 90 per cent, for instance 88 per cent or 89 per cent, yet the commercial reality is that in essence all the risks and benefits of ownership have been transferred.

43. It is possible that a situation could arise where the lessee treats the lease as a financing lease, whereas the lessor considers the lease as an

operating lease. However, this lack of symmetry does not necessarily mean that either party is manipulating the guidelines. Factors that should be considered are (a) differing discounting rates may have been used by the two parties, (b) the lessee may not know the initial cost to the lessor and assumes a different fair value and (c) the contract may include an early termination clause which either party may or may not elect to exercise.

44. Another anomaly can arise if significantly lower risks are retained by the lessor and additional risks are accepted by the lessee, and the present value of the minimum lease payments is substantially below 90 per cent of the fair value. Assuming that the lessee elects to capitalize the lease, the question to be answered is whether the asset and liability should be recorded at fair value or at the lower net present value.

Transfer of ownership

45. Situations can arise where the intention to transfer ownership is not clear and is therefore open to interpretation. For instance, lease agreements in the aircraft industry may provide for the leased asset to be returned to the lessor at a given point in time, with the lessee absorbing a small share of any loss and the lessor reporting the greater share. Alternatively, the lessee could renew the contract yearly on similar terms or could convert the agreement from an operating lease to a financing lease or vice-versa. Such agreements are often classified as operating leases by the lessee. Consequently assets are used in the enterprise for a period of years, albeit much less than their productive life, but are not reflected in the lessee's balance sheet. Supplemental disclosure may be given.

46. Inclusion of the following terms or conditions within the lease agreement can cloud the distinction and make the distinction between an operating lease or financing lease debatable:

(a) Termination options and renewal clauses that make it difficult to determine at the commencement of the lease which options the lessee will exercise, even though the parties may have a clear understanding or intention between themselves;

(b) Right to exchange equipment in the event of obsolescence, which effectively transfers the risk of ownership to the lessor;

(c) Control over the resale of used equipment by the manufacturer, which bestows some unquantifiable benefit to the lessor.

Leases which include service agreements

47. Another debatable situation occurs when a finance lease is marketed as including a service agreement, with the instalment payment applying to both the leasing and maintenance components of the agreement. The lessee must approximate the relative proportions. If the lessee allocates a generous sum towards the maintenance components, the lease element may satisfy the less than "90 per cent net present value of minimum lease payments" test and be classified

as an operating lease. Increasingly, such arrangements are made for leases of computer equipment, to include substantial service contracts.

Book value of leased assets and corresponding liabilities

48. The method for evaluating leased assets is sometimes unclearly defined. For instance, under a non-cancellable lease the asset may become completely obsolete or impaired for some reason, and thereby no further economic benefits will be derived. If legal title has not yet been transferred to the lessee, then the asset simply cannot be sold by the lessee and only the scrap value will be realized by the lessor. Regardless, the outstanding lease obligations remain.

Leases which involve computers and software

49. Leases which involve computers can pose further classification problems due to the absence of a firm commitment to transfer ownership, particularly when the selection and ongoing requirements are indefinite in the light of constant technological developments. Due to greater flexibility and possibilities in the structure of purchase/lease agreements, the lessee may obtain a clause whereby provision is made to upgrade the equipment, or even for a complete change of equipment, once the contract has begun. Long-term contracts in particular may have such options. If the agreement does allow such flexibility, then the lessee may never own the equipment, nor have the intention to do so. As the ownership of the equipment may well change during the life of the agreement, it would be very difficult to justify capitalization as there would probably not be a bargain purchase option. Instead, the agreement is more likely to have a cancellation penalty. Had the lessee entered into a traditional purchase agreement and obtained external credit, then the item would have been capitalized.

50. Aberrations sometime occur for computer software, which is rapidly growing in complexity and is often specially tailored for a particular user, sometimes to the extent that it cannot be used by any other third party. Significant expenditures are currently being spent by enterprises for software. In 1990, leases accounted for just US$ 50 million in software sales, which is small in comparison to the US$ 32 billion United States software market. However, that market niche is growing at two or three times the 20 per cent annual rate of the overall software industry. 3/ As compared with the lease of industrial equipment, software cannot be resold at the conclusion of the lease term, nor repossessed should the lessee default. Essentially, the arrangement constitutes unsecured lending. Software producers and retailers are enthusiastic about leasing because they can receive up to the full purchase price at the inception of the lease (under a leveraged lease). The financiers must accept the risk. Accordingly, the inherent rate of interest is likely to be higher than the usua rate charged in leasing contracts.

Alternative criteria

51. Qualitative tests could be a more appropriate manner to establish whether all the risks and rewards of ownership have been passed from the lessor to lessee, thus trying to determine the substance of the agreement. For example:

(1) Are the rental amounts based upon a fair market price for use of the asset or on a financing rate for the funds utilized?

(2) Is the nature of the enterprise's business a factor?

(3) Are there "put" and "call" options? If so, are they at a specified or market amount when the option is exercised?

(4) Which party carries the risk of a decline in value and which party benefits from any capital appreciation?

(5) Does the lessee have the use of the asset for a period broadly equating to the likely useful economic life of the asset?

52. The following additional test should be applied to lessors:

(6) Does the lessor intend to earn its total revenue from the lease transaction only, or also from the subsequent residual sale proceeds?

III. CONCLUSIONS AND RECOMMENDATIONS

53. Clearly, the current requirements in IASC and national standards in certain countries to capitalize financing leases has partly solved the problem of properly accounting for off-balance sheet financing. More significantly, the concept of "economic reality over legal form" has been adopted as a legitimate practice in many countries. Nevertheless, this approach needs to be further refined to overcome the problems discussed above.

54. The United States has developed the most extensive guidelines on this topic as a response to the ever more complex financial arrangements which have evolved. If a guideline is circumvented, a further guideline or ruling is developed, using the historical cost model. Very regimented regulations have resulted, which try to cover complex situations. The guidelines should be applied in the spirit for which they were intended. An attempt has been made by the Australian Accounting Research Foundation (on behalf of the Australian Society of Certified Accountants and The Institute of Chartered Accountants in Australia) and the Australian Accounting Standards Research Board, to develop alternate accounting concepts (Statement of Accounting Concepts 4), which examines the substance of an arrangement, with less emphasis on form. Thus, much of the onerous substance tests of lease transactions can be avoided. This would require a departure from traditional historical cost accounting.

55. Current theory and practice for lease accounting has come a long way from the traditional historical cost concept. Now, preparers, auditors and users of financial statements have adopted the notion that items for which the entity does not have legal title qualify for recognition as assets. In addition, the approach for lease accounting has been instrumental in the present value basis of measurement becoming an acceptable method in the conventional accounting model. Present value techniques, while implicit in the measurement of monetary liabilities, were not commonly applied in the preparation of financial statements before the introduction of leasing standards. These standards were

the forerunners of present-day standards such as accounting within the insurance industry, particularly concerning actuarial activities, and financial reporting by superannuation plans or pension schemes, both of which require the application of present value techniques in the measurement of liabilities. 4/

56. The next step is to develop a further or second phase for lease accounting, particularly to prevent the avoidance of non-capitalization of financing leases. The traditional definition of assets and liabilities if broadened and redefined could overcome the confusion surrounding the recognition of lease assets and liabilities. Statement of Accounting Concepts 4 redefines assets and liabilities as follows:

> "Assets are service potential or future economic benefits controlled by the entity as a result of past transactions or other past events.
>
> "Liabilities are the future sacrifices of service potential or future economic benefits that the entity is presently obliged to make to other entities as a result of past events." 4/

57. In the Working Group's Objectives and Concepts Underlying Financial Statements 5/, paragraphs 49-51 state:

> "The future economic benefit embodied in an asset may flow in a number of ways. An asset may be: (a) used independently or jointly with other assets to produce goods and services to be sold by the enterprise; (b) exchanged for other assets; (c) used to settle one or more obligations; (d) distributed to the owners of the enterprise.
>
> "Assets include property, plant and equipment, financial leases ... long-term receivables ...
>
> "Assets may arise from past events, which may be cash or non-cash transactions. Assets may be purchased, exchanged for other assets, self-generated or received as grants or donations."

58. Paragraph 55 of Objectives and Concepts Underlying Financial Statements 5/ defines liabilities as follows:

> "Liabilities include long-term loans and debentures, short-term loans and bank overdrafts, payables, pensions and similar financial obligations. The scope of definition of liabilities in the present report covers obligations whose financial amounts can or cannot be estimated precisely."

59. The critical feature of the definition of assets is the notion of control, ignoring the requirement of legal title. That is, the ability to control benefits and the ability to reap the rewards of possession and deny access to others of that benefit. The economic substance of allowing the party to enjoy a valuable right which is conveyed in a lease agreement is captured by this definition.

60. In the Group's Conclusions on Accounting and Reporting by Transnational Corporations 6/ published in 1988, the following guidance on leases was provided in paragraph 116:

> "Leases not reflected in fixed assets and other long-term commitments should be appropriately described and quantified."

61. In the section of Conclusions 6/ on property, plant and equipment, paragraph 80 refers to leases as follows:

> "Financial statements should disclose property, plant and equipment providing information in regard to both owned and non-owned properties shown in the accounts. Leaseholds and improvements thereto should be included under this item where they are treated as assets."

62. The Group may want to consider giving additional guidance on the subject of leases considering the research on the subject in this report.

Notes

1/ A. T. Arcardy, R. K. Herman and M. T. Strianese, "Real Estate Sale-backs under FASB 98", Journal of Accountancy, June 1989.

2/ W. Mcgregor, "Accounting for Leases - a New Framework", Australian Accountant, May 1993.

3/ L. Therrien, "When New Software becomes a Budget-buster", Business Week, 17 September 1990.

4/ W. Mcgregor, "Accounting for Leases - a New Framework", Australian Accountant, May 1993.

5/ Objectives and Concepts Underlying Financial Statements, report of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (United Nations publication, Sales No. E.89.II.A.18).

6/ Conclusions of Accounting and Reporting by Transnational Corporations, report of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (United Nations publication, Sales No. E.88.II.A.18).